The Federal Report

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM

The Month in Washington: September 2007

The Congress returned from summer work period to find the atmosphere very much different than that expected before recess. Expected conflict over the much-anticipated report on the success of the President's Iraqi war "surge" policy and an equally anticipated deal on the State Children's Health Insurance Program (SCHIP, known as "Healthy Kids" in California) dissolved while a compromise emerged on operations at the Food and Drug Administration (FDA) that disappointed many in the public plan community when conferees struck the proposed process for generic biologic drugs from the bill. Economic fallout from the subprime mortgage mess continued to ensnarl banks, some hedge funds, and credit rating agencies.

Issues and Events

Senate Panel Hears From CalPERS, Others on Carried Interest Controversy

The Senate Finance Committee held a third hearing on the taxation of carried interest and private equity on September 6, this time focusing on pension fund involvement with the issue, since pension funds (public and private) account for about 40% of private equity capitalization. Chief Investment Officer Russell Read delivered the CalPERS perspective to the Committee, which also heard from experts on fiduciary matters.

Carried interest is the practice of paying some non-investor general partners in a fund with a slice of the investment earnings. This compensation has traditionally been treated as capital gains, and taxed at 15%, rather than earned income, which is taxed at up to 35%. The explosive growth of private equity, buy-out, and hedge funds – many of which use the carried interest compensation method and can pay a successful general partner hundreds of millions of dollars for their services – has brought Congressional attention to the practice, since the activities of general partners at these funds appear to many to be a straight service-for-salary arrangement.

Read said that private equity has become a valuable part of the CalPERS portfolio by offering solid returns and an additional asset class to enhance portfolio diversity. High returns and diversification make the assets attractive, but Read highlighted the ability to tailor the private equity partnership documents to address investor concerns as an attractive feature not available in many other investment vehicles. On the central issue of carried interest, Mr. Read noted that paying the general partner through carried interest aligns the interests of operations with ownership, a long-sought goal of the System among publically-traded companies. To further strengthen this tie, CalPERS requires the general partner of a private equity firm to "have skin in the game" by taking a personal ownership stake. Read concluded that CalPERS has an interest in finding the best funds, not the cheapest, and that fees are part of a complex mix of factors that produce a final return to the plan. CalPERS has no position on the proposal to change the tax treatment of carried interest, Mr. Read advised the Committee, and there is currently no consensus view in the public pension community on the issue, with the national public pension organizations (NCTR and NASRA) declining to take a position.

Professor Alan J. Auerbach, Director of the Burch Center for Tax Policy and Public Finance at the University of California, Berkeley, supported raising the tax rate on carried interest as a sensible step given that their actives seem to be "managerial," and managers across the nation are compensated through income, not capital gains. He believes that the effect of taxing carried interest as income would amount to about a 10 to 20 basis point reduction to investors for an average drop in pension fund returns of 2 basis points or less. The tax change would progressively produce revenue from an echelon of taxpayers well able to afford an increase in their tax burden. Dr. Auerbach noted that there could be significant tax avoidance issues as partnerships reacted to tax changes with new compensation packages meant to exploit loopholes.

Donald Trone, President of the Foundation for Fiduciary Studies, said that there would likely be little if any effect on pension investment in private equity and hedge funds from such a tax change. "Unfortunately, in many cases where fiduciaries have invested in hedge funds and private equity, speculative hubris has supplanted procedural prudence," he told the Committee, suggesting that the rush to this asset class will continue so long as they are "hot" investments. Trone said that no asset class is inherently imprudent; rather, "it is the way it is built and how it is used that determines whether the prudence standard has been met." Trone views funds' willingness to pay "exorbitant" fees as a sign that private equity and hedge funds are simply the next bubble readying itself to burst. He noted that these funds have transparency and audit record problems that can prevent even the most sophisticated investor from accurately evaluating their risk profile.

Committee Chairman Max Baucus (D-MT) issued a largely non-committal statement on the carried interest issue. He said at the hearing that "the data says to me that hedge funds and private equity funds need pension funds more than pension funds need [them]. And that means that hedge funds and private equity firms may not have the economic power to simply pass along the increased costs to pension funds."

Baucus' Republican counterpart, Ranking Member Chuck Grassley (IA), put a sharper edge on his statement by asserting that "there are some pension plans that have an alarming amount of the plans' assets invested in these risky investments, and in funds that are not registered with the SEC. This gives me pause." He said that he fully understands that the market involves risk but that "I fear the day that a pension plan goes under because a hedge fund or sectors of the private equity industry go under."

Currently tepid Senate interest in changing the taxation of carried interest could change depending on House action and market events. While Senate Finance has held three hearings on various aspects of the issue, leaders Baucus and Grassley have held off from offering broader legislation on carried interest. Although their bill, S. 1624, would tax publically traded investment partnerships like corporations, they have not developed a measure similar to that of Congressman Sander Levin (D-MI)'s H.R. 2834, which would end the current more generous tax treatment of carried interest across the board.

House Tax Chairman Promises "If It's in the Code, It's in the Bill"

Concerns over the Alternative Minimum Tax (AMT) and election politics are fueling momentum for a large tax bill covering a broad range of issues. Charles Rangel, Chairman of the House Ways and Means Committee, told reporters this month that "If it's in the [tax] Code, it's in the bill." Legislation could move as early as this fall, although that might be an overly-optimistic timetable for a complex tax measure. Still, Rangel insisted in late September that he is piloting a tax bill 747 and Speaker Nancy Pelosi is the "air-traffic controller" who will tell him when he can land.

A large tax bill will be used by Democrats to showcase their version of "tax fairness." A host of issues that purportedly contribute to income inequality may find their way into the legislation, which House leaders plan to pay for under the pay-as-you-go rules (known as "PayGo") that require new tax breaks or spending to be offset by cuts. Ways and Means held a tax fairness hearing on September 6 that previewed the politics of the issue, including the tax treatment currently afforded private equity managers, with calls for fairness to the middle class from Democrats countered by Republican concerns for growth, investment flow, and the health of the economy.

However, reforming the AMT provides the driving force to a new tax bill. This unindexed parallel tax system intended to make high earners pay some taxes has crept into the middle class and become a recurring problem for Congress, which has passed temporary patches that hold off, but do not correct, AMT bracket-creep into the main body of taxpayers. Another patch this year will cost $50 billion; an 11 year fix under one plan will cost $872 billion. The declaration that tax legislation will obey "PayGo" means than virtually any tax provision could be in play to pay for the AMT changes. Should Rangel's larger tax fairness measure proceed, even more tax expenditures will shift from place to place, creating new winners and losers. Given the substantial place of pension rules in the tax code, and the revenues associated with the tax-favored treatment they provide, pension plans could be in play as well.

The Senate is not believed to have equally ambitious plans for a tax measure this year. Rangel said that a strong showing from the House could persuade the Senate to follow suit. However, the differing rules of the chambers mean that the Senate must always be more mindful of the minority party and consequently more moderate in its approach if it hopes to get things done. Senate action will likely depend on whether Senate leaders perceive the tax product from the House as having enough viability in their chamber to make a similar effort on their side worthwhile.

SCHIP Founders: Face of Healthcare's Future?

At one point earlier in the session, renewal and expansion of the State Children's Health Insurance Program (SCHIP, which is known as "Healthy Kids" in California) seemed an easy bipartisan issue that would allow both parties and both chambers to walk away feeling good about policy and politics. However, over the course of the last few months, the issue mutated from expansion of this program to one involving the ideological future of healthcare as a whole, raising crucial questions about the roles of government and private insurance in providing coverage.

The development of SCHIP into a partisan issue brought the bill to a conclusion common for any such legislation: the measure, which would expand SCHIP by $35 billion over 5 years to cover several million additional kids, could not muster sufficient votes to override a promised Presidential veto, passing the House of Representatives on September 25 by 265-159, well short of the two-thirds vote needed. Although both chambers might proceed with a veto override attempt for political reasons, observers believe there is little chance of success.

SCHIP provides government assistance for healthcare to the children of the working poor who make too much for Medicaid but still cannot afford insurance. Over the course of the program's 10 year history, waivers from the Department of Health and Human Services (HHS) have allowed program modifications moving away from the baselines originally established in the statute. Consequently, eligibility now varies by State, with some States allowing coverage for families with incomes up to 200% of the Federal poverty level while others set the bar at 300% of poverty. However, the Administration has decided to halt this process, and recently denied New York State's recent waiver request to cover those up to 400% of the poverty level.

GOP opponents of the bill held fast up in the closing hours before the vote. Brian Kennedy, spokesman for House Minority Leaders John Boehner (R-OH), told the press "The Democrats' bill does more to ensure that government-run healthcare gets a fighting chance in Washington than it does to insure the kids who need affordable health care in this country. Americans … don't believe that well-to-do adults with private insurance should get a government handout under a children's program." Many in the GOP characterized the program as government-run medicine and outright socialism.

"I wasn't aware that Senator [Orrin] Hatch (R-UT) and Senator [Chuck] Grassley (R-IO) were socialists," quipped Congressman Rahm Emanuel (D-IL). The Senate largely prevailed in conference, where their version of the bill, originally adopted by a veto-proof vote of 68-31 earlier in the year, was essentially left unchanged. Democrats are expected to provide a temporary extension of the program, allowing them to bring the issue back every three months until the elections next November.

The SCHIP fight appears to illustrate that the consensus for healthcare reform has not yet hit a tipping point, although it is close. Apart from the argument over whether the current political mood – including frigid relations between the White House and Congress –

allows anything substantial to be done, the alignment of interests on healthcare still favors deadlock, with no clear popular opinion on the roles of government and private insurers. Both institutions enjoy dismal levels of confidence from the public, and these negatives allow both sides to attack the other. Until conditions cause the professional political class to find real consensus on the politically "obvious" solutions to the current healthcare system, where coverage continues to erode and rising costs gut incomes, stalemate is the likely future for healthcare reform.

Subprime Markets Continue to Dominate Investment News

Continuing effects from the subprime mortgage situation engaged Capitol Hill as legislators sought solutions to the market crunch affecting millions of homeowners, threatening to drag down the entire economy as home sales sag. As the turmoil persists, threats of lawsuits became a further complication to returns on this asset class.

An investor group is targeting the Bear Stearns hedge funds that underwent a rapid collapse over the summer, losing nearly 90% of their value. Separate legal action commenced against a variety of mortgage lenders involved in the subprime market. Lawyers for the investors claim that the funds withheld material facts on investment performance that would have affected the investors' decision to invest more or withdraw their capital.

Rising numbers of lawsuits in the financial field should remind investors that the pivotal *Stoneridge* case comes before the Supreme Court shortly. *Stoneridge* involves whether and to what extent third parties bear responsibility for fraud committed by their clients, and what standard of reasonableness should apply to who is guilty of what. Although the Securities and Exchange Commission (SEC) argued for a pro-investor position in the case, other parts of the Administration prevailed on other economic grounds. The result was an Administration *amicus* in support of the business interests, which fear a widening web of potential liability. The Supreme Court will hear the case on October 9, 2007.

NCPERS Drops Opposition to Tax Change on Carried Interest

Reversing itself, the National Conference on Public Employee Retirement Systems (NCPERS) told the Senate Finance Committee through a September 4 letter that the group has no position on proposals to change the tax treatment of carried interest, a compensation arrangement used by certain partnerships such as hedge, private equity, and buyout firms that treats managers' income as capital gains rather than regular wages. The Federal government taxes regular wages at up to 35% while capital gains enjoy a lower rate of 15%.

The public pension group had previously supported the preservation of the current tax treatment for carried interest, arguing that a change would undercut returns for investors. According to the Private Equity Council, public pension plans contribute substantial capital to these funds, providing about 27% of the capital invested in private equity in 2006.

The new letter from NCPERS President Robert Podgorny informed the Senate that the majority of NCPERS members did not support its previous position. "While some of our members feel that the bills could affect the public plan community, the majority of our members do not share that opinion," he wrote.

A September 5, 2007 letter from the presidents of the National Association of Retirement Administrators (NASRA) and the National Council on Teacher Retirement (NCTR) to Finance Committee Chairman Max Baucus (D-MT) and Ranking GOP Member Charles Grassley (R-IA) -- noting that “there have been recent media reports regarding the position of public pensions on this issue” -- stressed that NASRA and NCTR “remain steadfast in our commitment to not interfere with Congressional efforts to develop tax policy in this area, and our position to neither oppose nor support specific legislation on this issue.” The letter underscored that the membership of the two organizations includes the executive directors, trustees and staff of the largest public pension plans in the nation, including every State, territory, and teacher retirement system as well as the largest statewide retirement systems for municipal, county and other public employees.

As the NASRA/NCTR letter explained, “The public pension community understands that whenever the Congress considers policy changes – from tax code adjustments to modifying business standards or requirements – there is the potential that such changes could raise costs for an industry, thereby potentially lowering returns for investors.” However, “as State and local officials,” the letter continued, “we also understand that there is a wide range of issues beyond that of investor returns Congress must consider as it contemplates these policy changes.” The letter concluded by noting that NASRA and NCTR will “continue to review legislative proposals for direct and/or indirect implications on public pension funds.”

In a related development, Congressman Sander Levin (D-MI) plans to push a proposal to treat carried interest compensation as regular income for purposes of the Medicare FICA tax, resulting in a 2.9% reduction in net pay. In addition to the lower tax rate, capital gains are not subject to payroll taxes such as that used to fund Medicare and Social Security.

Experts Tell Senate Panel IT Must be Part of Universal Coverage

The Senate Budget Committee heard testimony on September 11 on the effect of health programs on the Federal budget. This hearing focused on universal coverage as a potential remedy for exploding costs.

The need for health information technology (HIT) arose as a surprising theme from the hearing. Henry Aaron of the Brooking Institution stressed that, separate from the issue of universal coverage, new technology should be applied universally to bring needed efficiency and cost-savings to the system. He mentioned electronic health records and e-prescribing as prominent technologies that should be adopted as quickly as possible and scolded Congress for the miserly amounts of funding granted and proposed for HIT adoption. Sherry Glied, chairwoman of the department of health policy and management at Columbia University, largely agreed with Aaron's views. Janet Trautwein of the National Association of Health Underwriters addressed her testimony to other issues, such as employer and individual mandates, "Medicare for all" proposals, wellness programs, and other aspects of health costs.

A further complication for HIT in the current Congress is that a substantial number of the presidential candidates, particularly on the Democratic side, rely on savings from HIT to fund their healthcare proposals. Enactment of a HIT plan by the Democratically-controlled Congress could therefore blast a huge hole in the healthcare numbers of their party's candidates. Although both Congressional chambers passed HIT legislation last year, there has been no momentum on the issue this year as legislative leaders turned to issues such as SCHIP to be the centerpiece of their health agenda.

CalPERS Leads Call for Climate Risk Disclosure

CalPERS, the New York Attorney General, and others including California Treasurer Bill Lockyer petitioned the Securities and Exchange Commission (SEC) to require public companies to disclose their risk from climate and environmental causes. The petition asserts that these factors could have a material effect on earnings and thus should be presented to investors in order for shareholders to make informed judgments about the future prospects of the company in question.

Sectors thought to have substantial exposure to these risks include the insurance and energy industries. Critics such as the environmental group Ceres have pursued this issue since at least the beginning of the year by noting in January that they estimated half the S&P 500 did a "poor" job of disclosing climate change risk. Green groups have petitioned the SEC on this issue twice before without a response; the Environmental Defense website dubbed the new effort "first-of-its-kind" for the greater involvement of the investment community.

Many in the industry cited for press coverage of the petition explained that the apparently lackluster disclosure by public companies stems from numerous sources. The outcome of legislative efforts on climate change and environmental issues remains exceptionally difficult to predict, both in terms of passage and particulars, and the details of bills that may or may not pass could mean huge gains or losses. To this view, there is simply too much uncertainty to generate a meaningful number on climate-related risk.

The SEC had no comment on receipt of the petition and has not announced a timeframe for its consideration.

Outgoing SEC Commissioner Says Scrap Both Proxy Plans

Securities and Exchange Commission (SEC) member Roel Campos says that both proxy reform proposals issued this summer should be junked for a new plan more appealing to shareholders. Campos, who resigned from the Commission this month, made his comments before the Council of Institutional Investors on September 17. The two proposals in question offer diametrically opposed plans: one would effectively reverse the 2006 *AFSCME v. AIG* court ruling and once again permit the exclusion from a company's proxy materials of all shareholder-proposed bylaws concerning director nominations; the other would permit an exception, or override, to this general bar, permitting shareholders with a 5% equity stake in a company, held for at least one year, to propose such election-related bylaw amendments. Campos characterized both proposals as "horrible" and "very bad." Many investor groups hold that the 5% threshold is too high to be effective.

Campos' replacement has not been named but, by law, someone other than a member of the President's party must take his seat. During his tenure, Campos was a strong supporter of shareholder rights and heavier punishments for corporate misdeeds, particularly in the accounting area. His absence gives the commission a temporary 3-1 advantage of Republicans over Democrats. However, Cox has also developed a sound record on supporting shareholders' interests. The Commission may thus offer some interesting dynamics until the open seat is filled.

Mental Health Parity Advances

The Senate cleared a measure (S.558) to guarantee that insurers offer mental health benefits on substantially the same terms as that offered for coverage of physical ailments, approving the measure by unanimous consent with the backing of Senate Health, Education, Labor, and Pensions (HELP) Committee Chairman Ted Kennedy (D-MA) and Ranking Member Mike Enzi (R-WY). The House may act as soon as mid-October by bringing up its version of the bill, which has 270 of the 435-member House as cosponsors.

The legislation follows up on 1996 law that set basic elements of fairness into insurance coverage for mental health. The new bill extends the concept of parity between mental and physical health coverage to deductibles, co-pays, lifetime cost limits, and hospital stays, among other provisions. Previous language in the Senate bill that pre-empted State mental health parity laws was dropped during negotiations. As the Administration has not issued a veto threat against the measure, it could well become law by the end of October.

FDA Bill Passes Congress; Biogenerics Dropped

The House voted September 19 to approve H.R. 3580, legislation reauthorizing the Prescription Drug User Fee Act (PDUFA) for the Food and Drug Administration (FDA) by a huge margin of 405-7. The Senate answered the next day by passing the measure unanimously. The bill took on new priority as the FDA announced that it would have to begin staff cutbacks if the legislation did not clear by September 21. The PDUFA provisions allow the FDA to fund the approval process for drug and medical device companies' products through user fees.

The measure, a compromise between House (H.R.2900) and Senate (S.1082) efforts, should receive the President's signature shortly. It increases user fees by about 25% to $400 million and gives FDA the authority to order post-market studies on drug safety and fine those who do not comply. Drug advertising would be reviewed more closely by FDA and new ads would be required to include ways to report side effects. New technology would combine claim and other data to identify safety problems in the market rather than rely on consumer anecdotes, as is current practice. The legislation grants extended exclusivity for some new pediatric drugs, begins to tighten conflict-of-interest rules, and requires that the results of clinical trials of already approved drugs be made available to the public through a National Institutes of Health (NIH) run database.

The Senate provision on establishing a process for generic biologic drugs similar to the current process used for chemical drugs did not make it into the conference report. Senator Mike Enzi (R-WY) told reporters on September 18 that Congress will return to the biogeneric issue "at another time." Previous reports suggested that a once-split industry had re-circled the wagons to press for a delay in the biogeneric proposal so that both sides would have more time to shape the plan to their liking. However, exile from this legislation, which the industry considered crucial and FDA made a priority, probably means that there will be no biogeneric drug approval bill in this Congress.

Strategic Recommendations

LGV&A is not offering any new strategic recommendations to the Board this month.

California Congressional Delegation

Waters Leads Housing Bill to Passage

Congress moved on the troubled housing market as the House passed H.R. 1852, a substantial package of housing market reforms, on September 19 by a 348-72 vote. Authored by California Congresswoman Maxine Waters (D-Los Angeles), the legislation would expand the Federal Housing Authority's maximum principal loan obligation, tighten requirements for down payments, increase disclosure, add rules for "high risk" loans to borrowers with low credit scores, provide authority to increase the amount of

Federal mortgage insurance, and limit increases in mortgage insurance premiums, among other provisions. The Senate has not yet announced plans to act on a counterpart.

As statistics begin to suggest that a troubled housing market can threaten the entire economy, Congresswoman Water's leadership in producing a bill to help stabilize the market marks a constructive, concrete, and swift reaction to the problem. While many other issues related to this problem area remain buried under words, the House bill could provide assurance that the considerable powers of the government can be sensibly redeployed to soften the tremors in the vital housing market.

Related National and Industry News

Tax Change on Health Benefits Troubling, Says EBRI

The Employee Benefits Research Institute (EBRI) warns in its latest issue brief of unintended consequences if a proposal to change the tax treatment of health benefits advances.

EBRI research suggests that unraveling the current tax treatment and limiting employers' tax deductions for health coverage at a certain level would cause the market to unravel. A similar effect comes from restricting the exclusion of health benefits from employee's taxes. EBRI contends that younger and healthier workers would follow the incentives to find cheaper care, slowly "poisoning" the pool with older and sicker employees who would generate increasingly more expensive care. The group said the dynamic of younger workers bailing out of the employer-provided insurance market creates a "death spiral" in affordable coverage that ends when no employer can finance obligations created by an adversely-selected pool.

More information is available at the EBRI website, http://www.ebri.org.

Credit Raters Under Fire for Alleged Inaccuracy, Errors

Congressional hearings in the fall will reportedly look at the credit rating agencies' role in the subprime collapse. Because the firms being rated pay the rating agencies, the appearance of conflicts of interest make a tempting policy and political target for lawmakers. Congressional watchdogs have not forgotten the perceived failure of the rating agencies to react to the deteriorating conditions at Enron, for example, which enjoyed positive ratings four days before it declared bankruptcy. The first of these hearings is scheduled for September 27 before the Subcommittee on Capital Markets; witnesses were not available at *Federal Report's* deadline.

A bashing before a Congressional Committee, deserved or not, is still far from establishing legal guilt, however. John C. Coffee, a law professor at Columbia University, explained that "Credit-rating agencies have never been held liable in any class-action suit since the beginning of time. They have had virtual legal immunity" for their statements, according to Coffee.

Facing investor incredulity and Congressional interest in their business practices, Moody's Investor Service announced that it would begin an internal review of the methods used to rate complicated securities and look at developing measures of market valuation and liquidity separate from the base credit categories (such as A, AA, etc.). Some have blamed credit rating giants Moody's and Standard and Poor's for not warning investors sufficiently about the problems with subprime mortgage securities.

Former Federal Reserve Chairman Alan Greenspan gave credit raters a mixed review in his comments to a major German newspaper. While opposed to further regulation of the industry on the grounds that the market will make the needed corrections, Greenspan said "People believed [credit rating agencies] knew what they were doing. And they don't." He added that investors should now know that there is really no way to accurately price some structured finance products, and predicted that there will be less of these products as that knowledge spreads. Loss of business among the credit raters, Greenspan contended, will be punishment enough to foist improvement upon the industry.